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The Manufacturers Hanover
Economic Report

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Monetarism Versus Realism

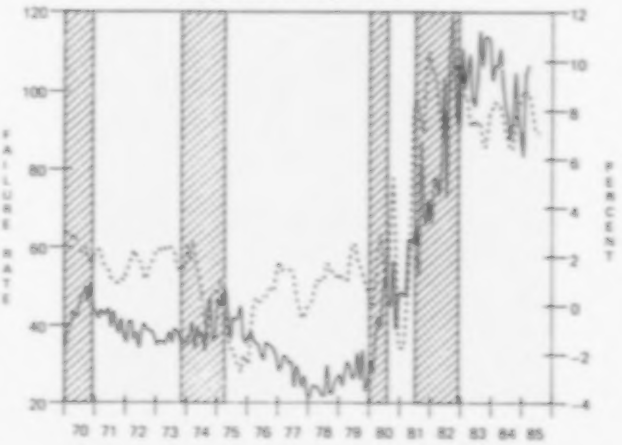
The first quarter's figures showing very slow growth in the real gross national product have once again focused the spotlight on the Federal Reserve. The central bank is being blamed for this slowdown by those who look no further than the top-line real GNP figure as well as by those who look beneath the surface. The 1.3 percent growth rate reported for the January-March period was not only less than one-third of the 4.3 percent annual rate of increase in the fourth quarter of 1984—it was also considerably below the 2.1 percent rate of growth reported by the Commerce Department in its "flash" GNP estimate released in March.

This shocked a number of economists who thought that the flash report was too low and that it would be revised upward. Since interest rates on most business and consumer loans remain in double-digits even though the economy has grown at a meager 2½ percent clip during the past three calendar quarters versus a sizzling seven percent pace in the previous six, and the rate of inflation is anywhere from 3½ percent down to zero, the Fed, quite naturally, has come under fire (Chart I).

Trade Deficit Depresses GNP

Those who look beneath the surface of this GNP report are no more mollified than their top-line counterparts. For a dissection of the numbers reveals that most of the slowdown was due to a widening of the trade deficit as measured in the GNP accounts (Economic Report—February 1985). Real domestic demand (real GNP minus net exports) rose at a 4½ percent rate in the first quarter compared with an increase of only 0.9 percent in the previous quarter (Chart II). While both the consumer and the business sectors participated in this advance, their purchases did not translate into corresponding growth in domestic output because a greater chunk of it was satisfied from abroad. After adjusting for inflation, imports in the January-March period soared by more than 26 percent while exports fell by more than eight percent. The strong dollar no doubt had a lot to do with this, and our high real interest rates compared with those of our trading partners had a lot to do with the rise in the value of the dollar to its overvalued levels.

CHART I
INDEX OF BUSINESS FAILURES PER 10,000 FIRMS (LINE) VS. REAL PRIME RATE, MOVED 6 MONTHS FORWARD (DOT)



If this were all, the Fed's decision would be simple. It would just increase the rate at which it provides money to the economy and the result would be lower interest rates. This would clearly give a lift to domestic economic activity by bringing down the cost of borrowing, thus easing pressures on the credit-sensitive sectors. It might also help our foreign trade position to the extent that lower interest rates would reduce the value of the dollar. However, the Fed's choice is not so clear-cut. For the money supply is already growing rapidly and any further increase in the rate of growth of money could very well revive inflation and the expec-

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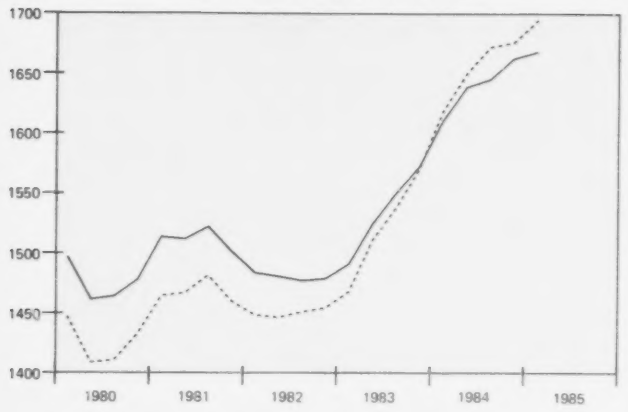
CHART II
REAL GROSS NATIONAL PRODUCT (LINE)
VS. REAL DOMESTIC DEMAND (DOT)
(BILLIONS OF 1972 DOLLARS)



tation of inflation—something the Fed has fought long and hard to damp down over the past five years.

This is not to say that the Fed isn't aware of its dilemma and is not trying to resolve it. It is. Back in February, in his semi-annual testimony before Congress, Federal Reserve Chairman Paul Volcker sent an important signal to the financial markets when he indicated that the conventionally-drawn targets for the money supply's growth should be altered (Chart III). The money supply was growing above the target ranges as they had been conventionally illustrated, but there was an obvious need to avoid tightening up.

The Fed Will Try...

Chairman Volcker indicated that the Fed should not be constrained by the cones which were narrow at the start of the year, widening only later on. He suggested, instead, parallel lines drawn back from the yearend boundaries: "We have sometimes considered, and others have suggested, a better 'pictorial' approach would be to illustrate the targets by a different (but also necessarily arbitrary) convention—parallel lines drawn back from the outer bounds of the specified fourth quarter target ranges to the base period ... The target range is then portrayed as maintaining the same width throughout the year."

Using this procedure gives the Fed more room to manuever in the beginning of the year, as is fairly obvious. However, it is also obvious that this procedure allows for more liquidity to enter into the economy since the growth rate of the money supply earlier in the year can be greater than otherwise under the narrow, or cone-shaped targets.

The big question is: How much liquidity can the Fed inject into the economy before it runs the risk of firing up inflation and the expectation of inflation? Judging by the miscalculations of those economists who are of the monetarist persuasion, and who estimated that the U.S. economy would encounter double-digit inflation by the end of 1984 because of rapid money growth earlier in that year, the Fed would seem to have a fair amount of leeway. Obviously, what threw off the monetarists' calculations was the rise in the value of the dollar.

As has been pointed out in the past, the super-strong dollar caused inflation pressures to diminish in a variety of ways. First, it dampened demand for commodities worldwide, since most of these commodities are priced in dollars and thus required much more in the way of local currencies. This dampened demand for these commodities which depressed their dollar price, but not by as much as other currencies were falling against the dollar. In the U.S., the strong dollar restrained exports since they were priced too high to compete in world markets. At the same time it encouraged a sharp rise in imports for the opposite reason. The U.S. was inundated with more goods than before which not only lowered their prices, but also induced domestic manufacturers to keep their prices down in order to remain competitive. In turn, pressure was put on labor to restrain wage increases—effectively reversing the wage-price spiral of earlier years.

The Fed can't take too many chances with inflation psychology. Thanks to monetarism, the financial markets are very much aware of the money supply's growth rate—not only on a monthly or quarterly basis but on a weekly basis as well. Too much above-target money growth without a suitable explanation from the central bank would reawaken inflation psychology—the strong dollar notwithstanding. Such inflation psychology would reappear first in the bond markets, as long-term interest rates would rise. This would obviously put the kibosh on business capital spending, homebuilding and anything else that requires long-term credit.

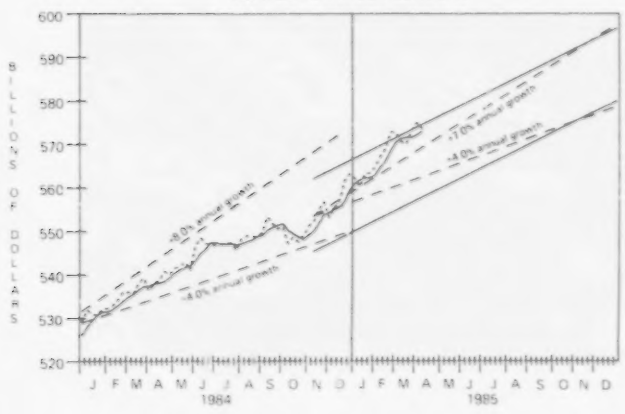
...To Keep Interest Rates Down...

By the same token, the extent to which the Fed might be successful in depressing short-term interest rates could very well precipitate another decline in the value of the dollar. In turn, this would reduce its restraining effect on prices. Plainly, the combination of excess liquidity already in the system as well as latent fears of inflation could easily be translated into higher prices as the flow of goods leaving this country picks up while the flow of goods coming in slows down in response to

changes in the foreign exchange value of the dollar.

I think the Fed will be a realist—not a monetarist. Besides the signal already sent to the markets by broadening the target bands, Fed officials have also pointed out that velocity, or turnover of money, has been lower than usual. "There is some analysis that suggests the trend of velocity over time may be a little lower than the trend of three percent or so characteristic of much of the postwar period when interest rates were trending higher," said Chairman Volcker back in February. "Should developments during 1985 tend to confirm that somewhat lower velocity growth, and provided that inflationary pressures remain subdued, the Committee (the Federal Reserve Open Market Committee) anticipates that those aggregates (the money supply in its various definitions) might end the year in the upper part of their ranges." In plain English, this means that the Fed might be prepared to accept even faster money growth if it is evident that the velocity or turnover of money is insufficient to move the economy ahead at a desired rate.

CHART III
MONEY SUPPLY, M1
FOUR-WEEK MOVING AVERAGE (LINE)
VS. WEEKLY FIGURES (DOT)



Complicating matters are the well-publicized troubles that the Internal Revenue Service is having with its computer system. It has resulted in delayed payouts of refunds and a consequent swelling of Treasury balances at the Federal Reserve. This is causing the Fed to have to inject additional reserves into the commercial banking system in order to keep interest rates from rising as funds flow out of commercial banks into Federal Reserve accounts. Obviously, once the Treasury catches up and refunds go out, these funds will flow back into the banking system. No doubt this will boost money growth further, complicating the Fed's strategies and the markets' interpretation of them.

...So Business Can Grow

One thing seems certain: The Fed is not likely to tighten anytime soon. The last thing the Fed (and the economy) needs is for interest rates to go shooting up. Not only would such a development slow overall economic activity, but it would also hit hard at such sectors as those depending on foreign trade, homebuilding, and agriculture, to name three. On the other hand, it should be realized that the Fed can't keep interest rates down forever. The credit needs of a growing economy, combined with the needs of Washington to finance its budget deficit, will keep the demand for money strong. The Fed may accomodate these demands for a while, but it cannot be expected to do so indefinitely.

Once the Fed stops accommodating, interest rates will go up. One way or another after that, the economy will slow to the point of recession. Either higher interest rates will attract funds from abroad thereby driving the dollar up, depressing the foreign trade-sensitive sectors further, or these higher interest rates will strike the credit-sensitive sectors of the domestic economy first such as homebuilding, autos, and capital goods forcing the economy down in a similar mode.

The Ultimate Solution

The solution, then, lies not with the Federal Reserve, but with Washington and its budget deficit. The politicians are deluding themselves if they think that because the business expansion has made it this far while the deficit has grown and remained large, the economy can continue to grow even if nothing is done about Washington's red ink. For the deficit has already affected economic activity. By keeping interest rates high compared with inflation, it has hurt not only the credit-sensitive sectors of our domestic economy like autos and housing, but also our foreign trade position by attracting funds into this country, thus boosting the value of the dollar.

The next step is for Washington's budget deficit to actually throw the economy into reverse. This will happen if the deficit remains unchecked and the Federal Reserve decides that it can no longer avoid tightening up on the money supply. No doubt at that time the Federal Reserve will be the scapegoat once again.

However, those who would criticize the Fed should take a leaf from the comic strip character Pogo who said, "We have met the enemy and he is us." H

Great golf! Great cause! Great price!

The Manufacturers Hanover Westchester Classic will be held at the Westchester Country Club in Harrison, N.Y., June 3-9, 1985.

- Tickets for the Sports House and Grounds for 7 days—$60. Grounds only—$45. Monday and Tuesday (practice rounds)—$5 or $3 per day. Wednesday (the Pro-Am)—$10 or $6. Thursday, Friday, Saturday, Sunday—$18 or $15 each day.
- Scott Simpson, defending champion and other top pros from the PGA Tour, will compete for $500,000 in prize money.
- Proceeds help support the following area hospitals: United, Lawrence Auxiliary, New Rochelle, Northern Westchester, Phelps Memorial, St. Agnes, St. John's, St. Joseph's, St. Vincent's, Blythedale Children's, Greenwich, Mount Vernon, White Plains, Yonkers General.
- Tickets on sale at all these hospitals through June 2, thereafter at the gate. To charge with MasterCard or VISA call 212-308-8513.
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